

Primer on evaluation of risks in securitisation transactions

August 2023

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1 Executive summary

A securitisation transaction is very different from conventional lending. In the latter, a lender advances loan to a borrower and receives principal repayment and interest payment over time. In the former, the lender sells the right to receive future payments from the borrower to a third party and obtains a consideration for it much before the actual maturity of the original loan. Given this distinction, investors in securitisation transactions encounter risks quite different from those involved in conventional lending. Therefore, analysis of risks in securitisation transactions requires a separate framework.

The following four categories of potential risks provide the starting point for a meaningful analysis of securitisation transactions:

- **Credit risk** arises on non-payment by underlying borrowers in the pool of loans because of the inability or unwillingness to pay. Analysis of the nature of the underlying asset class, robustness of the origination processes, past performance of the originator's overall portfolio and pool characteristics will provide pertinent insights into the credit risk associated with the underlying borrowers.
- **Counterparty risk** arises on account of non-performance of counterparties involved in the transaction. The key counterparties to be analysed are the servicer, the designated bank and the swap counterparties. CRISIL Ratings assesses counterparty risk using a combination of qualitative and quantitative factors; it analyses the quality of the processes and systems at the counterparties and, where required, employs credit rating as a proxy for the ability of the counterparties to perform over the tenure of the transaction.
- **Legal risk** arises if the originator goes bankrupt and there is a possibility that the bankruptcy court may attach the securitised receivables and decide that the pool cash flow should not be specifically earmarked to the investors in the securitisation transaction. To assess this risk, CRISIL Ratings studies the relevant transaction documents and requires the originator to furnish an independent legal opinion addressing the relevant legal issues and uncertainties associated with the transaction. CRISIL Ratings then conducts a detailed analysis of the legal documents to assess whether there is a valid sale of the securitised assets and whether these assets are bankruptcy remote from the originator.
- **Market risk** arises on account of factors external to securitisation transactions such as prepayment of loans, movement in interest rates and macroeconomic factors. CRISIL Ratings incorporates these risks in its analysis by applying stress levels commensurate with the transaction structure.

2 Scope

This article¹ provides an introduction to the risks faced by investors in securitisation transactions. It also throws light on the CRISIL Ratings analytical framework for evaluating such transactions, the criteria for identifying the risks in a

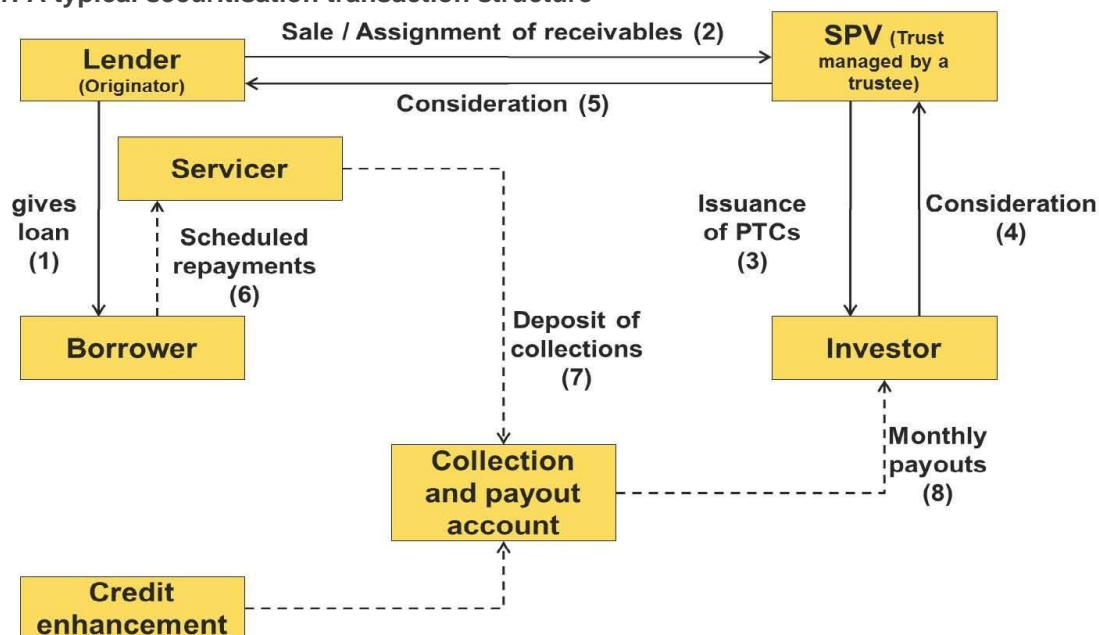
¹ The previous version of this article, which was published in September 2021, can be accessed here: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/structured-finance/archive/Evaluating-risks-in-securitisation-transactions-A-primer-Sep-2021.pdf

transaction and assessing whether these risks are commensurate with the rating assigned. The risk assessment framework discussed here is applicable to pass-through certificates (PTCs) as well as direct assignment transactions.

3 Understanding securitisation

Typically, securitisation transactions involve sale of loan receivables by the originator (a bank, non-banking finance company [NBFC], housing finance company or a manufacturing/ service company) to an intermediary (a special purpose vehicle [SPV]), typically set up as a trust (*Chart 1*). The SPV issues PTCs to the investors and the proceeds are paid as a consideration to the originator. In this manner, the originator, by selling its loan receivables to the SPV, receives a consideration from the investors much before the maturity of the underlying loans. Collections from the underlying loans held by the SPV are passed on to the PTC investors. The transaction is provided with limited credit support or credit enhancement in the form of fixed deposits or guarantees, which provides protection to investors against defaults by the underlying borrowers.

Chart 1: A typical securitisation transaction structure



In short, the basic characteristics of a typical securitisation transaction are as follows:

- Receivables are sold to the SPV
- Investors subscribe to PTCs issued by the SPV and can, therefore, be repaid only out of collections from the underlying receivables held by the SPV
- As the originator has **sold** the receivables, the investors' recourse to the originator is limited to the credit enhancement provided by the originator at the time of securitisation

An alternative securitisation structure, called a direct assignment, is also prevalent in the market. Direct assignment transactions involve assignment of a pool of loan receivables directly to the investor without any association with the

SPV. Credit enhancement is not permitted in direct assignment transactions involving banks or NBFCs as either a buyer or seller as per the current regulations².

3.1 Common cash flow structures used in securitisation transactions

Structures have evolved based on the risk appetite of the investor, tenure preferences and issuer requirements. The common structures include:

- **Fully amortising structures**

Fully amortising structures are designed to closely reflect the full repayment of the underlying loans through interest and principal payment. Here, the principal is repaid to the investor along with interest over the tenure of the PTC. This is different from bullet structures where the entire principal is repaid at maturity.

- **Par and premium structures**

In par structures, the investor pays a consideration equal to the pool principal outstanding (par value). In return, the investor is entitled to receive scheduled principal repayments from the pool of receivables along with a pre-decided rate of interest. Par structures have an element of excess interest spread (EIS) generated, wherein the yield of the pool is higher than that on the PTCs. The originator has the right to receive the EIS amount.

A premium structure is one where the investor pays a consideration greater than the pool principal outstanding for the right to receive all the cash flow arising from the securitised assets.

- **Senior subordinate structures**

Cash flows from securitised assets can be carved into multiple classes/ tranches of securities with different tenures and risk profiles. The senior class is accorded the first claim on cash flow from the pool, whereas the subordinate class has a lower claim. Thus, in the event of shortfall in the pool collections, the subordinate class provides a cushion to the payments on the senior class.

- **Fixed and floating rate structures**

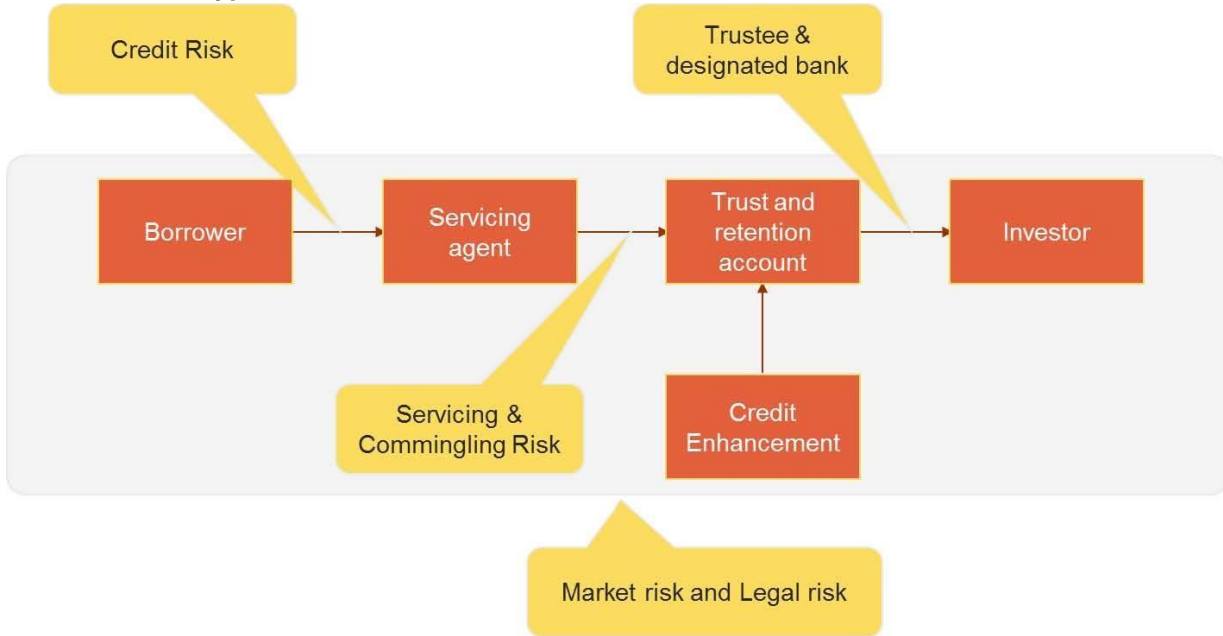
PTCs can be issued at fixed as well as floating rates of interest. A floating rate of interest is linked to a designated index or benchmark rate. If the underlying pool comprises fixed rate loans, then floating coupon rates introduce an element of interest rate risk in the transaction. This risk can be mitigated by using an interest rate swap with a swap provider.

² Please refer to the Reserve Bank of India (RBI) Master Direction – Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021

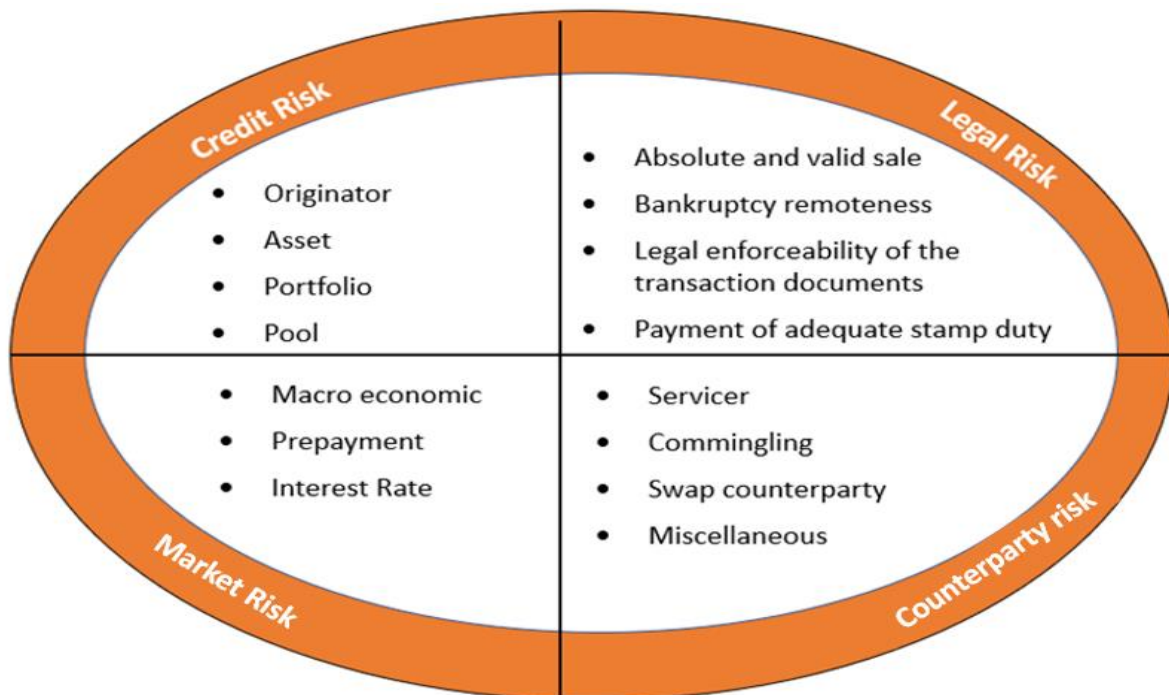
4 Framework for analysing risks and mitigants

Investors in a securitisation transaction are exposed to several risks at each stage of the transaction. The schematic representation below shows the potential sources of risks in a typical securitisation transaction.

Chart 2: Risks in a typical securitisation transaction



CRISIL Ratings, in its analysis of securitisation transactions, uses a four-quadrant framework to identify, classify and evaluate risks. All the relevant risk factors identified (as shown in the schematic diagram above) fall under one of the four quadrants.



The four quadrants represent the fundamental risks in any securitisation transaction.

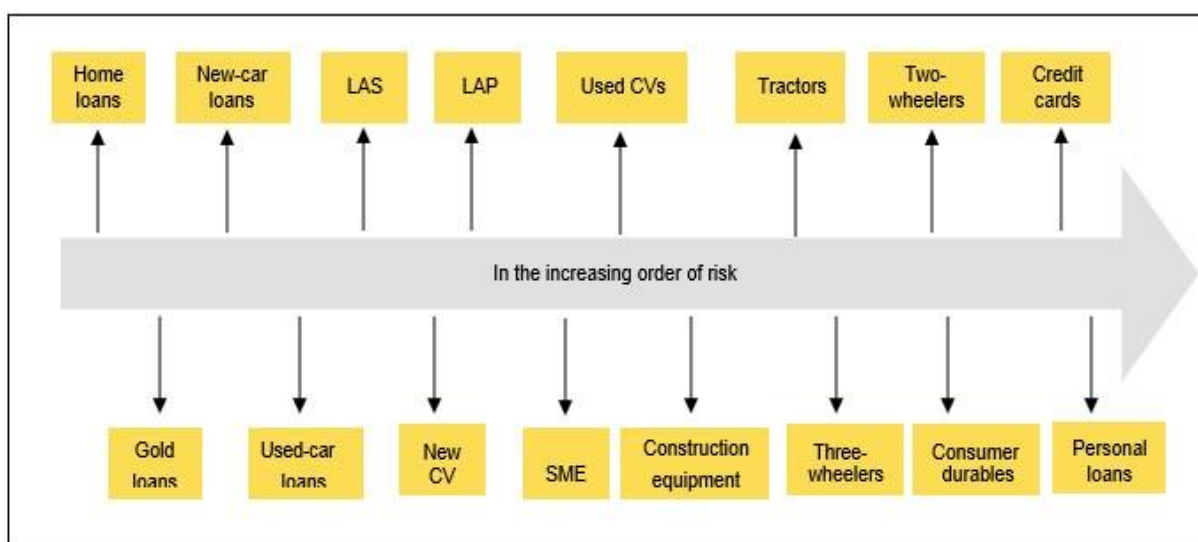
- **Credit risk** or the risk of default by the underlying borrowers
- **Counterparty risk** or the risk of failure of the counterparties involved in the transaction
- **Legal risk** or the risk centred around sale and transfer of receivables from the originator to the SPV
- **Market risk or risks arising because of the macroeconomic environment**

• Credit risk

Credit risk forms a critical element in the analysis of securitisation transactions. Typically, in securitisation transactions involving a pool of loans, credit enhancement is provided to cover shortfalls in pool collections vis-à-vis investor payouts, primarily on account of defaults by the underlying pool borrowers. The level of credit enhancement is sufficient to cover shortfalls in pool collections commensurate with the assigned ratings. For determining the sufficiency of credit enhancement, the key factors evaluated are:

Asset risk

The nature of the underlying assets is a crucial indicator of the performance of the pool. For instance, receivables backed by home loans extended to salaried borrowers display a completely different collection pattern compared with receivables backed by commercial vehicle (CV) loans. The CRISIL Ratings risk continuum provides a fair indication of the relative risk levels in the underlying retail loan assets, which is duly factored in when determining the sufficiency of credit enhancement for various asset classes. Everything else remaining constant, low risk assets need lower credit enhancement than high risk assets. However, in the case of securitisation transactions involving corporate loans, the analysis focuses primarily on CRISIL Ratings' credit view on the underlying borrower(s).



Originator risk

The originator of the assets plays a key role in the transaction. Even within a specific asset class, originators may choose to focus on lower risk or higher risk sub-segments as part of their strategy. Hence, the quality of origination and underwriting norms impacts the performance of assets. While strong origination systems and processes enhance the quality of assets, inadequate origination systems and ineffective processes lead to poor quality of assets. A robust risk control mechanism and availability of strong management information systems (MIS) are other prerequisites for the creation of a strong portfolio. CRISIL Ratings undertakes a detailed analysis of the originator's processes, right from the generation of leads to post-disbursal documentation and collection processes to gain insights into the quality of asset creation. This analysis provides key inputs for the evaluation of the pool being securitised.

Portfolio risk

The pool to be securitised is to be carved out of the portfolio consisting of a set of outstanding loans disbursed by the originator. The originator's track record in this asset class and past delinquency patterns of the portfolio could provide pointers on the possible performance of the securitised pool. For example, historical losses in an originator's car loan portfolio could be used as a leading indicator of possible future losses in a car loan pool. In addition, the delinquency levels of an originator's portfolio are compared with those in the same asset class for other originators as part of the benchmarking process adopted by CRISIL Ratings.

Portfolio analysis is a key component of the risk assessment framework in a securitisation. It is conducted in two forms: static pool analysis of past originations and dynamic portfolio analysis to understand the performance of recent originations. This is discussed in detail in our criteria document titled 'CRISIL's rating methodology for ABS transactions', available on www.crisil.com.

Pool risks

The quality of the pool is a crucial element in assessing credit risk. CRISIL Ratings takes into consideration pool characteristics such as pool seasoning (or the number of instalments paid by the borrower to date—the higher the seasoning, the better the quality), overdue at the time of selection and loan to value (LTV) ratio, as these are good indicators of the future performance of the pool.

Furthermore, CRISIL Ratings benchmarks pool characteristics with the overall portfolio characteristics to identify positive or negative deviation in the pool quality from the portfolio quality. The parameters compared include geographic distribution, LTV, original tenure, borrower profile and interest rate. Based on the benchmarking, if the pool is ascertained to be weaker than the portfolio, CRISIL Ratings applies a higher level of stress on the pool cash flow. On the contrary, if the pool appears to be cherry-picked based on a positive selection criteria, the stress levels applied will be commensurately lower.

CRISIL Ratings also evaluates whether the pool is exposed to concentration risks at the borrower as well as geographical level. All else remaining equal, a concentrated pool would display higher variability in performance and, hence, would require greater credit enhancement compared with a granular pool. The geographic concentration is evaluated at a state, city or district level depending on the asset class. For instance, for a residential mortgage-backed securitisation transaction involving housing loans, geographic concentration is evaluated at a city level, as real estate trends are fairly local, whereas for microfinance loans, the concentration is usually evaluated at the state and district levels.

- **Counterparty risk**

Several counterparties are involved in a securitisation transaction and their steady performance is crucial for the smooth functioning of the transaction. In a securitisation transaction involving a pool of loans, the credit risk is modelled to determine the sufficiency of credit enhancements. However, counterparty risks are typically digital in nature and are too large to be modelled to determine the sufficiency of the credit enhancement. Stringent counterparty selection and replacement requirements form the basis of the criteria to ensure counterparty risks are commensurate with the assigned rating. Key counterparty risks to be factored in a typical transaction are:

Servicer risk

The servicer plays a crucial role in a securitisation transaction in the Indian context, especially in transactions involving retail assets. Investors are susceptible to the risk of bankruptcy and non-performance of the servicer. Consequently, the sustained performance of the servicer over the tenure of the pool becomes a crucial element of the securitisation process.

CRISIL Ratings evaluates the quality of the management team; the collection processes, strategies and follow-up mechanisms; and the quality of the MIS systems of the servicer. CRISIL Ratings also considers the tenure of the securitised instrument and the credit rating of the servicer, which is taken as a proxy for its ability to continue servicing the pool over the tenure of the transaction.

Commingling risk

In most securitisation transactions, there is a time lag between pool collections and investor payouts. Typically, the servicer collects money from the underlying borrowers in the pool in a particular month and deposits that amount into the trust and retention account in the next month. In the interim, the money collected lies with the servicer and may commingle with its own cash flow. While the collected amount is held in trust by the servicer, in the event of the servicer going bankrupt, there could be total or partial loss or delay in recovery of the commingled amounts on account of legal proceedings.

As monthly pool collections are commingled only for a short period of time, the short-term credit quality of the servicer determines the commingling risk. Consequently, CRISIL Ratings takes into account the relevant short-term credit rating of the servicer while evaluating the commingling risk.

Swap counterparty risk

In securitisation transactions, interest rate swaps (IRS) can be used to mitigate the interest rate risk (defined under the section 'Interest rate risks' within 'Market risks'). In transactions that employ IRS, the payouts to investors depend on the payments received from the IRS counterparty. Hence, the credit risk of the IRS counterparty is relevant to the transactions.

Counterparty risk linked to credit enhancement

Credit enhancement can be provided in two ways:

- Cash collateral, which involves maintaining credit enhancement in the form of cash and equivalents
- Guarantee, where the originator arranges for a bank or corporate guarantee for the equivalent amount

If the cash collateral is in the form of a fixed deposit, investors are exposed to the credit risk associated with the bank holding the fixed deposit. Likewise, if a guarantee is provided, investors are exposed to the credit quality of the bank or the corporate entity providing the guarantee. Consequently, CRISIL Ratings factors in the risks arising from these counterparties in its analysis.

A detailed discussion on the CRISIL Ratings approach to incorporate counterparty risks in its analysis can be found in the 'Forms of Credit Enhancement' section in the criteria document titled 'CRISIL's rating methodology for ABS transactions', available on <https://www.crisilratings.com/>.

- **Market risks**

Market risks represent risks extraneous to the transaction and include market-related factors that impact the performance of the transaction. For instance, a change in interest rates could impact the prepayment rates for assets. Similarly, a change in real estate prices could impact the performance of securitisation transactions backed by home loans.

CRISIL Ratings incorporates the relevant market risks into its analysis by stressing the cash flow based on the transaction structure and underlying asset class. Thus, the initial sizing of credit enhancement for the transaction factors in the appropriate level of market-related risks.

Macroeconomic risks

The performance of the underlying loan contracts depends on macroeconomic factors, such as industry downturns or adverse price movements of the underlying assets. For instance, a sustained decline in industrial production may result in a slowdown in the transportation industry. This may strain the cash flow of truck operators, which, in turn, may impact repayments on CV loans. Similarly, a steep fall in the prices of the underlying trucks may increase chances of default. The borrower may prefer defaulting on the loan and letting the finance company repossess and sell the truck rather than retaining it and continuing to pay instalments on time.

CRISIL Ratings applies the appropriate stress levels to the cash flow arising from the underlying assets to factor in these risks.

Prepayment risks

A combination of prepayments and volatile interest rates represents a difficult situation for investors. Typically, prepayments of retail loans increase with a reduction in interest rates, leading to a reinvestment risk for investors. Investors may receive their monies ahead of schedule and may not be able to reinvest the amount at the same yield. In certain structures, separate prepayment strips could be carved out of the pool cash flow, which would be susceptible to volatility in the cash flow on account of prepayments in the pool being passed on to them. The prepayment strip ensures that other investors (other than those who have invested in the prepayment strip) are protected from volatility in the cash flow until such time that cumulative prepayments in the pool exceed the prepayment strip. CRISIL Ratings incorporates the relevant prepayment assumptions in its analysis of securitised instruments.

Interest rate risks

CRISIL Ratings has rated transactions with 'basis risk', where the loans in the pool are based on a floating rate, while investor payouts are based on a fixed rate or vice versa. This results in an interest rate mismatch and can

lead to a situation where the pool cash inflow, even at 100% collection efficiency, is not sufficient to make investor payouts. For such structures, CRISIL Ratings evaluates various interest rate scenarios to factor the interest rate risk into the credit enhancement. Interest rate swaps may be used in certain transactions to transform interest rate risk into a counterparty credit risk.

All debt and debt-like investments suffer from interest rate risks as any movement in interest rates has a direct linkage to the value of the security. However, CRISIL Ratings does not address risks related to volatility in the value of the rated instrument.

• Legal risks

Securitisation-specific legislation and a long track record of judicial decisions lend a high degree of predictability to the legal position on securitisation transactions and facilitate the creation of transparent and well-established legal criteria for such transactions. However, in the Indian context, such transactions are structured by the counterparties within the framework of RBI guidelines, the Transfer of Property Act, 1882, Indian Trust Act, 1882 Indian Contract Act, 1872 and applicable stamp laws.

Securitisation transactions in India are primarily carried out through two routes:

- Pass-through certificate issued by a special purpose vehicle (SPV)
- Direct assignment of loans

The RBI has issued guidelines³ for securitisation and direct assignment transactions, which stipulate conditions for carrying out such activities in India. One of the basic conditions for securitisation is absolute and valid sale of the assigned assets, which ensures that the underlying assigned assets are not impacted by the bankruptcy of the seller after the sale. An assignment shall be valid and bankruptcy remote when the assets transferred are put beyond the reach of the originator or its creditors even in voluntary or involuntary bankruptcy proceedings and/or administration and the transferee have unrestricted rights to the asset. A valid and absolute sale shall establish that the rights and duties with respect to the assets are transferred to the buyer and these assets are, therefore, bankruptcy remote from the originator's estate. Any dispute over the legal ownership of the assets is likely to result in uncertainty regarding investor payouts from the pool cash flow. Furthermore, an unfavourable ruling by an Indian court could result in outright loss for the investors, apart from raising questions over the basic concept of securitisation.

While CRISIL Ratings evaluates all pertinent legal risks in a securitisation transaction, the assessment of the bankruptcy remoteness and validity of the sale aspect is of paramount importance. Therefore, all transactions are backed by independent external legal opinion on the bankruptcy remoteness and validity of the sale alongwith the enforceability of the transaction documents by the transaction counsels.

CRISIL Ratings' legal risk evaluation framework

The CRISIL Ratings framework for evaluating legal risks in a securitisation transaction covers risks that could be detrimental to investors and the mitigating factors for such risks. While CRISIL Ratings uses its criteria for

³ These guidelines are applicable to counterparties regulated by the RBI.

evaluating credit, market and counterparty risks, legal risks need to be examined through the documents provided to CRISIL Ratings as part of the transaction.

The three key aspects evaluated by CRISIL Ratings under this framework are:

- a) Bankruptcy remoteness
- b) Stamp duty
- c) Nature of credit enhancement

a) Bankruptcy remoteness

As highlighted earlier, bankruptcy remoteness of the receivables and the credit enhancement is the building block of a securitisation transaction and the most important aspect in the legal risk evaluation framework. A test of bankruptcy remoteness will establish that the assets/exposures transferred are put beyond the reach of the originator or its creditors even in voluntary or involuntary bankruptcy proceedings and/or administration and the transferee have unrestricted rights to the assets. Hence, CRISIL Ratings examines this through the transaction documents which is also backed by an independent legal opinion from an external legal counsel.

CRISIL Ratings examines the following to ensure that the sale of receivables is bankruptcy remote:

a.1) Extent of recourse to the originator and risk retained by the originator in the assets

A valid and absolute sale occurs when the seller effectively transfers all risks and rewards pertaining to the asset to the buyer. This would result in the buyer having no recourse to the seller after the sale, except to the extent of credit enhancements (if any) provided by the seller. It is important to consider the extent to which the investor will have recourse to the originator, as this reflects the risk retained in the assets by the originator.

The higher the level of risk retained by the originator, the greater the chances that the courts may not consider the assets as having been transferred from the balance sheet of the originator. There is a possibility that in cases where the originator retains a high level of risk in the assets, the courts may reclassify the securitisation as 'secured borrowing' by the originator. This would vitiate the bankruptcy remoteness of the transaction. Therefore, CRISIL Ratings may regard transactions with unusually high risk retention by the originator as being inconsistent with the RBI guidelines.

If the originators or investors are regulated by the RBI, the transaction should be compliant with its applicable guidelines. Among the various conditions, the originator needs to adhere to the minimum retention requirement. This is primarily designed to ensure that originators have a continuing stake in the performance of the securitised assets to ensure they carry out proper due diligence of the loans to be securitised.

In India, the originator usually continues as the servicer of loans in securitisation structures. CRISIL Ratings believes this does not violate validity of the sale as long as there are no additional liabilities taken on by the originator beyond fulfilling the role of a servicer collecting payments from the borrowers in the pool.

a.2) Option and obligation to repurchase assets

A securitization transaction should result in a complete transfer of risks and benefits, and the seller should not be obligated to repurchase assets or support the transaction after the sale of assets unless it is done through invocation of a clean-up call option in terms of the RBI guidelines. Some transactions in the PTC structure may

have a call option. The threshold at which the originator can exercise the call option should not be more than 10% of the original value of the underlying exposures or securitization notes.

Nevertheless, in transactions where the terms may require the SPV to use cash collections during the revolving period of the transaction to buy fresh assets from the originator (based on the predefined eligibility criteria being met), CRISIL Ratings does not consider such provisions as being inconsistent with the regulatory requirements.

a.3) Intention of the parties

As with most legal analysis, the intention of the parties is important to establish an absolute and valid sale and is often scrutinized by the courts to determine the same. Therefore, it is important that the language used in transaction documents clearly conveys the intention of the parties and that the nuances of the transaction do not have the potential to vitiate the validity of the sale. For instance, the price at which the assets are purchased is an important consideration for establishing the intention of the parties. An unfair purchase price can be scrutinised by the courts and could question the validity of such sale of the transaction. CRISIL Ratings examines each transaction document to check that the terms of the proposed transaction (as shared by the originator in the term sheet/draft information memorandum) are appropriately incorporated in the executed documents.

a.4) Extent of control retained by the originator over the assets

For a transaction to be valid and bankruptcy remote of the originator, the originator should have minimal control over the sold assets. The transferred exposures should be legally isolated from the originator in such a way that the exposures are put beyond the reach of the originator or its creditors, even in bankruptcy specially voluntary and involuntary Insolvency proceedings and/or administration and the transferee have unrestricted rights to the assets. Hence, CRISIL Ratings will examine such covenants and analyse the level of control that the originator continues to have following the sale.

a.5) Appointment of originator as servicer

In India, the originator usually continues as the servicer of the assets in securitisation transactions due to lack of backup servicers. While the appointment of the originator as the servicer is prima facie not considered to be a violation of the validity of the sale, the details of the obligations of the servicer are examined. For instance, if the servicer indemnifies the transferee from payment defaults by the obligors or if the originator takes on servicing of assets without adequate consideration, this could vitiate the validity of the sale. While transactions may not have an adequate servicer fee⁴, CRISIL Ratings believes the servicer consideration is factored into the purchase price upfront in most transactions.

Additionally, the transferee could have the right to appoint another servicer if the originator fails to comply with the terms of the servicing agreement. Such a right gives greater control to the transferee.

CRISIL Ratings also bases its analysis of a transaction on an independent legal opinion. For each transaction, we require the originator to obtain a legal opinion from an independent counsel confirming that the transfer of assets is valid and absolute sale .

⁴ Most agreements quote a minimal fee, which may not be the total consideration for the servicer

b) Stamp duty and registration laws

Stamp duty is an important issue unique to securitisation transactions executed in India. Indian states are empowered to determine their own stamp duty rates, which vary widely among states.

CRISIL Ratings examines the executed documents in each transaction and requires representations and warranties from the originator and an independent legal opinion confirming that the documents adhere to the relevant stamp and registration laws. The reasons for this are:

b.1) Consequences of stamp duty evasion

The consequences of evading stamp duty are serious. In terms of the Indian Evidence Act, 1872, documents that are required to be stamped and have not been duly stamped (either unstamped or inadequately stamped) cannot be adduced as evidence in a court of law. This renders the documents unenforceable, unless the deficient stamp duty is paid at the time of enforcement. Additionally, an inadequately stamped document attracts an enormous penalty, sometimes up to 10 times the deficiency in stamp duty paid.

b.2) Bearing the cost of stamp duty

The stamp duty payment liability is usually decided by way of contract between the parties to any transaction. In the absence of such an agreement, the general rule is that the person claiming the benefit of the document should bear the stamp duty levied on that document. It is important to note this because the person liable to pay the stamp duty is also liable to pay penalties or fines, if any, with respect to the same.

b.3) Differential rates of stamp duty

Stamp duty laws vary across states. Because of the differential stamp duty rates, if a document executed in one state is taken to another, it is liable to be stamped in the second state if the stamp duty there is higher. Therefore, it is essential that the underlying security (if any) for the transferred receivables is located in states with similar or a lower stamp duty than the state in which the transfer document has been executed.

CRISIL Ratings examines the transaction documents to evaluate whether the transaction complies with the relevant stamp duty regulations so that no future liability arises on this account to the investors.

b.4) Registration of documents transferring interest in immovable assets

In terms of the Transfer of Property Act, 1882, any document evidencing the transfer of immovable property or interest in immovable property has to be registered with the registrar of land records for the area where the property is located. Documents that transfer legal or beneficial interest should, therefore, be registered to ensure the rights of the investors are not legally impeded.

Typically, in the Indian context, due to high stamp duty rates on conveyance of immovable property, the mortgage security interest continues to be held in the name of the originator. This also enables the originator to exercise all enforcement rights available in relation to the mortgage security interest. However, the originator has an obligation to transfer the mortgage security interest as and when requested by the trust.

c) Nature of credit enhancement

Credit enhancement in a securitisation transaction can be provided in two ways:

- Internal credit enhancement
- External credit enhancement

Internal credit enhancement is provided through various structural features such as excess interest spread, over collateralisation and subordination. For a detailed understanding of the analysis of internal credit enhancement in securitisation transactions, please refer to the criteria article titled, 'CRISIL Ratings' methodology for ABS transactions.

External credit enhancement is provided through external forms of support such as:

- Cash collateral
- Guarantee

Cash collateral

Credit enhancement, though typically provided by the originator, does not vitiate the validity and the genuineness of the transaction as long as it is bankruptcy remote from the originator. This means that even in the event of bankruptcy of the originator, funds in the cash collateral account should be available to the trustee for paying the investors. Cash collateral can also be provided in the form of a fixed deposit.

Some of the aspects analyzed by CRISIL Ratings for evaluating bankruptcy remoteness are:

- Is the cash collateral maintained in a separate account?
- If the account is current, then do the documents expressly state that the money in the account is being held in a trust for the benefit of the trustee and is managed independently by the trustee basis the instructions received from the investors?
- If the cash collateral is in the form of a fixed deposit, are the maturity proceeds of the deposit endorsed in favour of the trustee upfront? The originator may, however, be a beneficiary to the residual amounts, if any, in the fixed deposit after payments from the same have been made.

CRISIL Ratings examines the transaction documents that lay down the mode of operation of the cash collateral account and the rights and liabilities of the respective parties with respect to the account. Additionally, CRISIL Ratings requires the originator to furnish an opinion from an independent legal counsel confirming the bankruptcy remoteness of the cash collateral from the originator.

Guarantee

If the credit enhancement is in the form of a guarantee, CRISIL Ratings follows the framework⁵ used for evaluating guarantee-backed transactions.

Independent legal opinion

Legal risks in a securitisation transaction are many and need to be evaluated appropriately. While CRISIL Ratings undertakes the analysis of legal risks in a transaction, it also relies on external legal opinion on certain aspects.

⁵ For details, kindly refer to CRISIL Ratings criteria: "Criteria for rating instruments backed by guarantees"

As a policy requirement, for every transaction, CRISIL Ratings requires the originator to obtain an independent legal opinion from an external transaction counsel⁶ to confirm the following:

- That the transfer of the assets is not in contravention of the underlying loan documents
- That the transfer of the assets to the buyer constitutes an absolute and valid sale
- That the receivables assigned to the trust are bankruptcy remote from the originator
- That the credit enhancement
 - If in the form of cash collateral, is bankruptcy remote from the credit enhancer/ originator
 - If in the form of a guarantee, is enforceable by the trustee and meets critical principles for legal adequacy as per CRISIL Ratings criteria (Please refer CRISIL Ratings criteria “criteria for rating instruments backed by guarantees”)
- That the transaction documents are valid and enforceable, and in compliance with the currently applicable law
- That all transaction documents have been duly executed in accordance with the prevailing stamp duty, registration laws

5 Conclusion

The above discussion provides a conceptual construct for the evaluation of securitisation transactions. While rating securitisation transactions, CRISIL Ratings analyses the key risks such as credit, counterparty, legal and market risks.

⁶ The content of the opinion will, however, vary depending on the facts of a transaction.

A quick checklist for a securitisation transaction

Our rating rationales and the information memorandum for the transaction provide a comprehensive overview of the transaction, the risks involved and the mitigants for these risks. A brief checklist, which investors can use for understanding the risks involved in a securitisation transaction, is provided below for reference.

Credit risk:

- **Analysis of the originator**
 - Track record
 - Systems and processes
 - Past performance of similar pools by the originator
 - Disclosures by the originator with respect to the above
- **Analysis of the pool**
 - Nature of the asset class backing the underlying loans
 - Pool quality in terms of parameters such as seasoning, geographic diversity, loan size and LTV
- **Coverage provided by the credit-cum-liquidity enhancement vis-à-vis the historical trend of losses in that asset class for the originator**
- **Counterparty risk:**
 - Track record of the counterparties
 - Credit quality of the counterparties
 - Experience in handling securitisation transactions
- **Legal risks:**
 - Valid and absolute assignment of the assets from the originator to the Trust
 - Presence of an external independent legal counsel
 - Reputation of the external independent legal counsel
 - Coverage of all the relevant issues in the legal opinion viz. Bankruptcy remoteness of the assets, payment of adequate stamp duty, compliance of all the applicable laws, legal enforceability of the transaction documents etc.
- **Market risks:**
 - Extent of prepayment and interest rate risks, level of mitigation of these risks structurally or through credit enhancement

Provisional ratings

Since May 2015, CRISIL Ratings has been assigning 'provisional' ratings for structured obligations, where necessary. This was in compliance with the guidelines from the Securities and Exchange Board of India (SEBI)⁷. The provisional nature of such ratings is disclosed by CRISIL Ratings in its communications, including rating letter and rating rationale. SEBI also mandates disclosure of rating that would have been assigned in the absence of the

⁷ As per SEBI directive on Standardizing the term, rating symbol, and manner of disclosure with regards to conditional/ provisional/ in-principle ratings assigned by credit rating agencies' by SEBI dated May 06, 2015 and April 27, 2021 circular 'Standardizing and Strengthening Policies on Provisional Rating by Credit Rating Agencies (CRAs) for Debt Instruments' by SEBI

pending steps / documentation. As CRISIL Ratings would not be able to rate the securitization transaction without the pending steps/documentation – as these form the very basis of the ratings - CRISIL Ratings will disclose the fact that no rating would have been assigned in case of absence of the steps/ documentation considered while assigning provisional rating.

Once the relevant documents (as per expectation when the provisional rating was assigned) are in place, the provisional rating will be converted into a final rating as per defined timelines. For more details, please refer to CRISIL Ratings' Policy on Provisional ratings, available on www.crisilratings.com

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